

5

Funding Needs During the Eleventh Five-Year Plan

American historian G. Waldo Browne said China was a country whose “gigantic possibilities are dwarfed by its present realities.”¹ Browne wrote at the beginning of the 20th Century, and his comments are as true today, a hundred years later, as they were then. The country may one day realize its potential, but that day will be in the distant future, not during either the current five-year plan or the next one, the Eleventh, which ends in 2010.

The People’s Republic will face its greatest challenges during this decade. To see why, we need a little historical perspective. Mao Zedong created an abnormal society, but he was at least enough of a realist to surround his new republic with high and strong walls so that it could survive almost indefinitely on the inside. His successors have sought to create a more modern nation, but they have not changed the Maoist system, in which the Communist Party dictates and the people are supposed to follow. Yet at the same time China’s new leaders have successively opened the country. As they do so, all the forces that apply around the world--economic, political, and social--begin to apply in China as well. At some point in this process this centrally-directed system will be subjected to unprecedented stress. As China opens itself up to the world, gravity, which applies almost everywhere else, must begin to apply in China too.

So the issue today is not whether the central government is doing the right things or the wrong things. The issue is time. Can Beijing solve its problems while it still has some measure of control within its borders?

From now until the end of the Eleventh Five-Year Plan, and especially during the next five years, the central government faces many challenges, some of them unprecedented. First, the central government’s finances are shaky and getting weaker. Massive fiscal stimulus undermines Beijing’s financial strength. Second, in the next few years the worst effects of World Trade Organization membership will be felt. WTO not only limits the leaders’ ability to defer solutions to problems but also takes away some of their tools to deal with them. Now the central government is no longer the sole master of the country’s economy. Third, the country must pass through the upcoming political transition as the current leadership passes into the background. Crucial decisions await the outcome of political struggle at the top. Finally, the country must keep its economy going forward in an especially uncertain world environment. At the same time, Beijing will have to deal with all the specific problems deferred

from the past half decade: bank nonperforming loans, pension funding deficiencies, environmental degradation, and the like. Because Beijing does not now approach them with the appropriate sense of urgency, they will not be solved during the current five-year plan. Yet at some point, the leaders will not be able to defer any more. These problems will worsen so that Beijing will address them during the next plan simply because it will have no choice.

Central leaders will undoubtedly use money to solve problems because it is the one tool that will still be available. Yet the stimulus program is losing its strength today, and it will be even less effective in the future. By using available credit, Beijing is postponing the onset of symptoms, but eventually the laws of economics will take over. At some point creditors, even the domestic ones, will refuse to support the stimulus plan. When that happens, China will still have the same problems, yet its financial condition will be far worse. We are only a few years from that time.

And what happens then? China has not experienced an annual decline in gross domestic product since 1976.² That decline will probably occur during the early part of the next five-year plan when the money runs out and the government can no longer stimulate the economy. A recession will just aggravate all the problems we see today, problems that are evident even when reported growth is high. We don't really know what will happen when the economy goes into reverse. Yet this we can see: America, and the rest of the world, needs to be prepared for the consequences of Chinese economic failure.

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I look forward to any questions or comments the Commissioners may have.

¹ “gigantic possibilities are dwarfed by its present realities”: Lehman

Brothers' recent research report derives its name from this quotation. *See* Alastair Newton and Robert Subbaraman, "China: Gigantic Possibilities, Present Realities," January 21, 2002.

² **since 1976:** *China Statistical Yearbook 2001*, p. 51.